DOW THEORY LETTERS INC.

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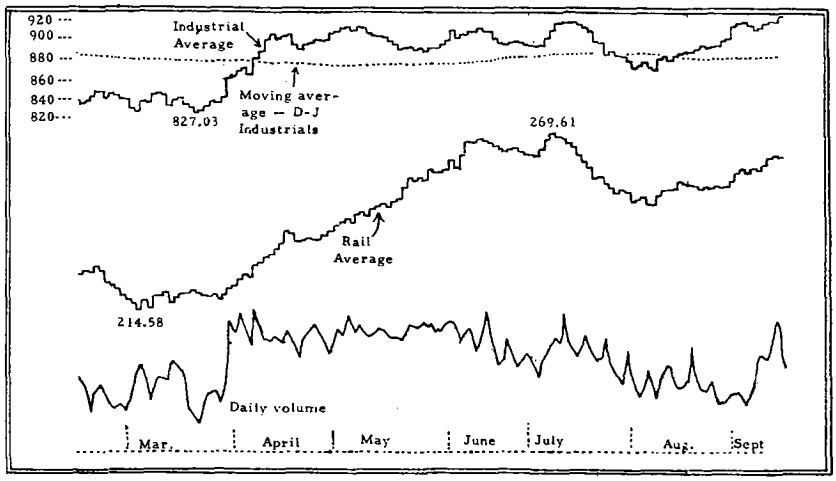
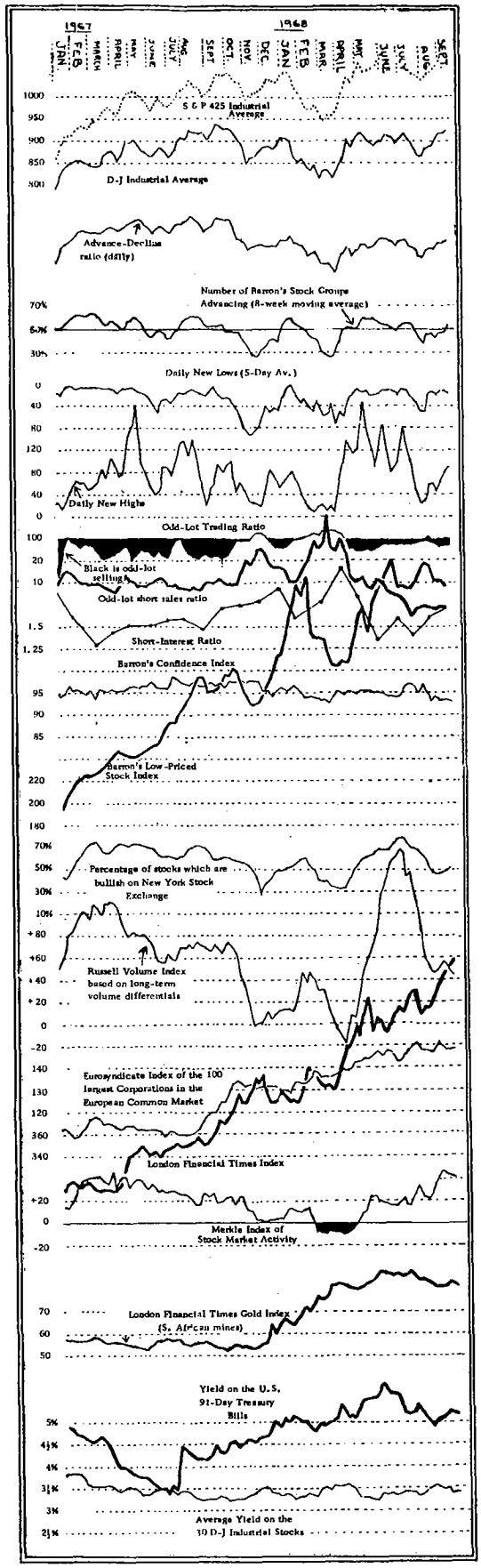
THE MARKET: The public and the fund buyers seem to have an almost unshakable faith in the ability of this market to hold or climb higher. The Czechoslovakian crisis, an event which would "normally" have thrown the market into a tizzy, exerted literally no pressure on Wall Street. Warnings of lower corporate earnings (due, if for no other reason, to the 10% surtax) have not dampened the buying fever. Monetary dislocations, a pound and a franc which could be devalued at any time, have not even moved stock buyers to caution.

Meanwhile, the price of gold (see later section) climbs slowly but relentlessly above the $40 level, thus placing the dollar at a better than 15% discount. Gold shares gather strength and push up with the market. The widely advertised collapse in interest rates fails to take place, but even here investors have learned to live with the problems of tight money.

Perhaps the greatest comfort for stock buyers comes from the knowledge that our Government is "locked into" a massive inflationary-spending program; the Vietnam war continues, West Germany puts pressure on the U.S. to move troops to Europe, the arms race shows no signs of abating. In a later section of this Letter I attempt to show why I believe our Government has a vested interest in "boom at any price." If that price is inflation, if that price is a shocking erosion in the value of savings, pensions, annuities, bonds, fixed dollar assets of any kind, that is the price that our politicians are willing to pay.

All of which is belieing the thesis that we are still in the deceptive second phase of a bear market which began on February 9, 1966. More than two-and-one-half years have passed since the Dow reached its all-time high of 995.15, yet people continue to have faith in inflation, the weakness of politicians, the inevitability of huge Government spending programs. Why, indeed, should people stop hedging their bets by turning in their common stock shares for dollars? What is to stop all that is happening from continuing to happen?



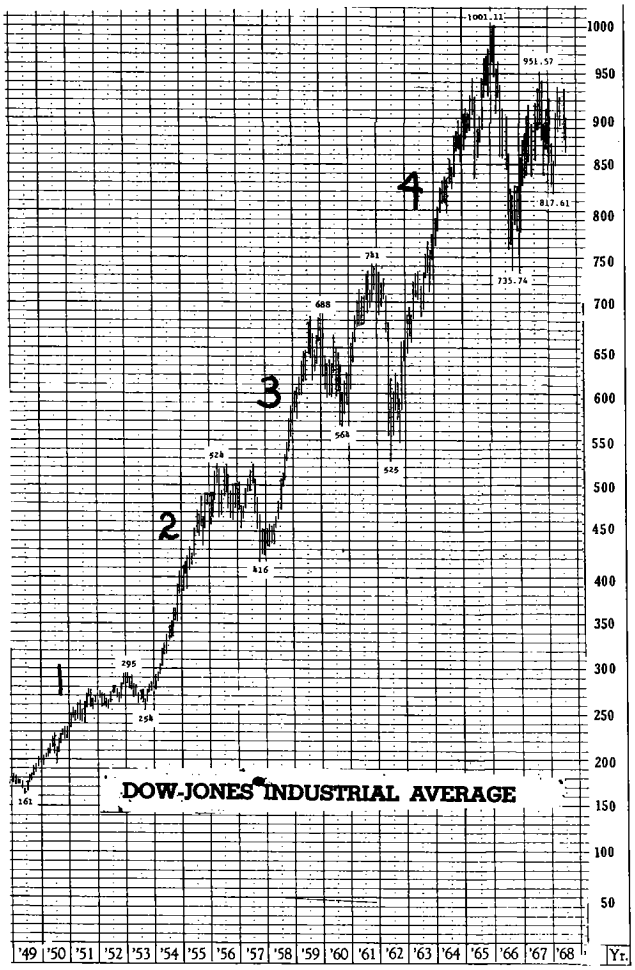

1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Av.)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Euroyndicate Index of the 100 largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Financial Times Gold Index ($, African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 10 D-J Industrial Stocks

 I can only say that under Dow Theory, a primary bear market has been underway since February, 1966, and that in due time the bearish forces will express themselves to the full. The longer this market holds up, the longer the speculation holds sway, the worse will be the ultimate day of reckoning, and the longer and deeper down the market will go.

A bear market serves to correct the excesses of speculation, spending, debt, and poor business practices, which accompanied the preceding bull market. But during the second phase of this bear market (from October, 1966 to the present) we have seen the continuance of all the excesses of a typical bull market plus more. It is for this reason that I believe the downturn, when it arrives, will be more powerful, more frightening, more relentless, than anything the most devout sceptic envisions today.

As for policy, my policy has been to urge subscribers to get liquid, move to the sidelines, and wait out anything and everything which this bear market rally can produce. I have advocated a hedge position of 10% to 15% of assets in assorted gold shares. If inflation continues, the price of gold (still roughly at its 1934 level) will be subject to increasing upward pressure. If deflation hits, the only commodity which is sure to hold its value is gold. Furthermore, if depression takes over, it can be expected that politicians will attempt to raise Central Bank reserves and international liquidity by raising the price of gold (assuming they do not raise the price of gold prior to economic trouble).

While I am talking in terms of the big picture, it might be well for subscribers to study this monthly chart of the Dow Industrials which covers the period of 1949 to the present (chart courtesy of M.C. Horsey, Salisbury, Maryland 21801).



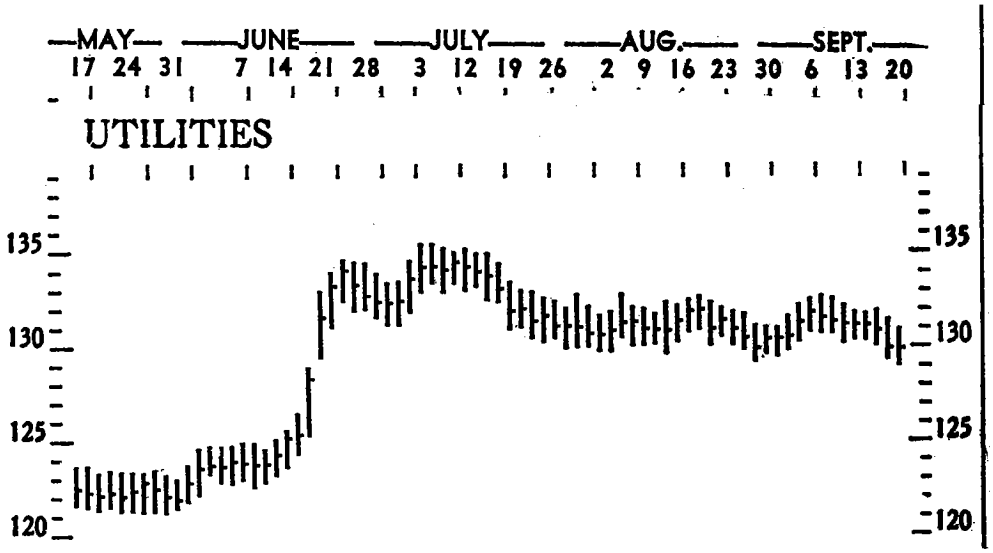
Here we see a series of four massive upward thrusts, each caused by expanding corporate earnings and increased inflation, and each taking the Dow to a new historic high (the four thrusts are numbered on the chart).

Starting in February, 1966, the pattern changes. Thirty-one months have passed since the bull market top of 1966, and this has produced the huge "congestion area" shown on the chart. For the first time, following a reaction such as 1953, 1957 or 1962, the Dow has failed to push to new historic highs. Furthermore, for the first time since 1949 the Dow has established a series of annual lower peaks, starting with the 995.15 of 1966, followed by the 943.08 of 1967 and the present peak in the 920's.

Obviously, this analysis could change in a week or a month. The Dow could conceivably rally first above 943.08, then above its all-time high. But until it does it is necessary for us to work with what is, and "what is" is a bearish pattern of declining tops over a period of almost three years. This is a definite departure from the entire pattern since 1949, and it is a pattern characteristic of a primary bear market.

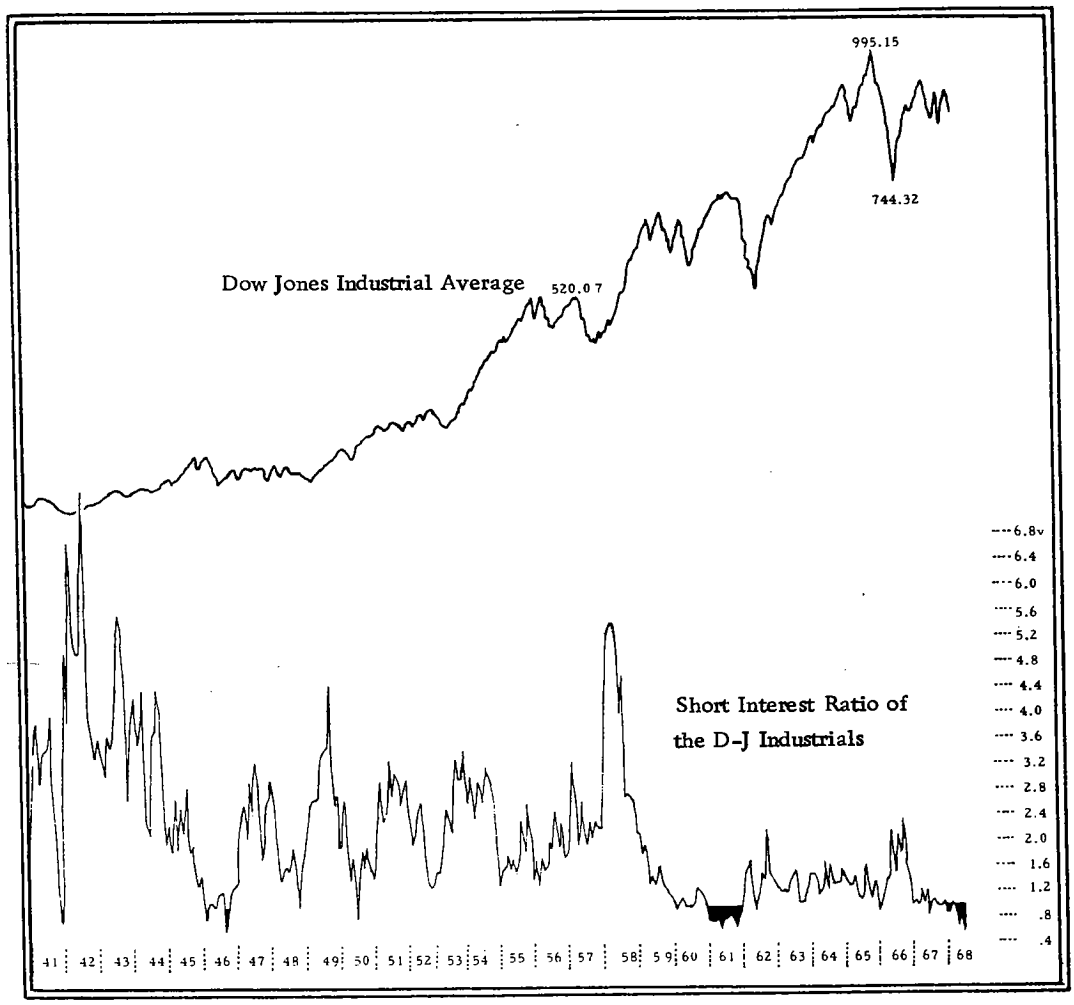
LACK OF CONFIRMATION: It is noticeable that the September 9 high (the 1968 high) of 924.98 recorded by the Dow Industrials has not so far been confirmed by other important indicators. The Rail Average is still well below its own 1968 high of 269.91. The advance-decline ratio has failed to push up above the September high. The D-J Utility Average, in the face of ostensibly easing money, has been the worst lagger of all. On September 19 the Utility Average closed at 129.98, actually below its August 29 low close of 130.02. Thus see chart (from the

Wall Street Journal) the Utilities on September 29 had fallen to their lowest level since mid-June.



As discussed before, the Utility Average over the past decade has had a habit of leading the market in regards to forthcoming advances or declines. It is therefore dramatic divergence when Industrials better their July high and Utilities not only fail to rally but break under all their lows going back to June.

A few technical factors are worth discussing at this time. The odd-lot figures are undoubtedly on the plus side at this time. As Garfield Drew (leading expert on odd-lots) states in this week's report, "Odd lot selling remains persistent and strength has tended to broaden to some extent during the past week which implies that the current advance has not been completed. Nevertheless, the market has not told a conclusive story for several months and short-term tops have developed with little warning."



Despite the hopeful odd-lot picture, two of the indicators which I watch are providing warning signals. One is the Russell Volume Index (see page 1 composite chart). This index is composed of the differentials of plus and minus volume on all N.Y.S.E. stocks plotted on a 60-day moving average. Over the past, major movements in this Index have (with a good degree of accuracy) predicted coming moves in the market.

From its late-June all-time high of 158, the Russell Index has moved sharply down to last week's low of 44. This huge drop has been accompanied by a definite downward zig-zag over the past month (another adverse sign). I can find no instance in the past where a drop of this magnitude in the Russell Index has not been followed by some sort of weakness in the Dow Industrials.

A second cause for concern is the short interest ratio in the Dow Industrials. In Letter 401 I discussed this index in detail, and I noted that it has been quite a bit more accurate than the standard short interest ratio of all stock on the N.Y.S.E. The Dow short interest ratio was developed by Bill Gordon of Indicator Digest, and I am indebted to him for the monthly figures.

Note on the accompanying chart (page 3) that the ratio for August stood at .67, one of the lowest figures on record. The .67 of August means that the Dow short interest has now held under the critical 1.0 level for 7 out of 8 months during 1968 (the single exception being the 1.13 reading of March, 1968). Thus the situation this year as far as the Dow short interest is concerned, is shaping up much like that of 1961 when the Dow short interest ratio held under 1.0 for an entire year prior to the 1962 collapse.

PREDICAMENT: About 85% of all the revenues of our Federal Government come from taxes on income and on employment (Social Security). Most people are shocked when they realize that the Social Security program has not set aside the cash to cover its Social Security commitments. The actual funds have long since been spent by the U.S. Government, and the only thing which keeps the program "solvent" is each year's new or additional income.

This is hardly the way any insurance company would run a similar plan, so that the whole Social Security set-up is actually a type of social "insurance" based on the income-gathering power of the U.S. Government. This Federal revenue-gathering power now demands such huge masses of funds each year that it becomes obvious that the U.S. has a fantastically vested interest in prosperity. Indeed, the U.S. cannot for a moment afford anything else but boom and expansion— and with it inflation.

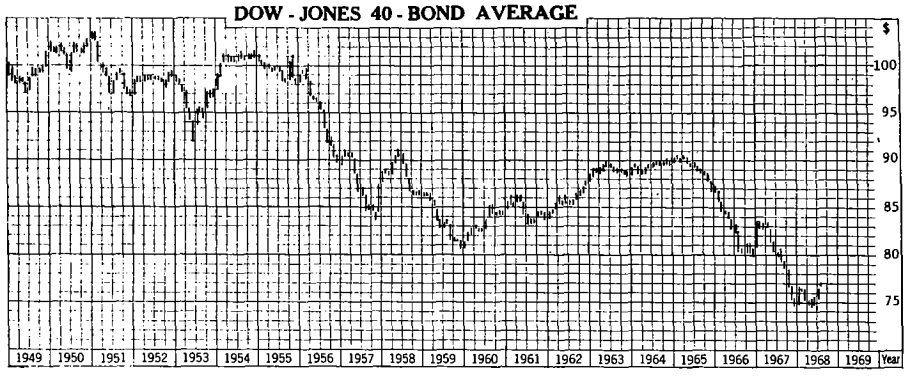
The private debt of the nation is now above $1 trillion of which $250 billion of this is in mortgages and another $100 billion is in installment debt. This debt must be serviced and interest must be paid. In order to service the debt, "full employment" is needed, so that the private sector of the economy, like the public sector, is totally dependent on full prosperity.

In other words, the U.S. (in both the public and private sectors) has placed itself in a gigantic bind. That bind consists of a relentless need for constant, current income to cover debt and expenses. The massive current income needed can only be produced by boom conditions (and the inflation which feeds the boom). Therein lies the problem, for as long as boom and inflation continue, the value of the dollar also continues to erode. No politician can take a chance on cooling off the boom, the Federal Reserve Board dare not slow the boom, there is no one who dare take his eyes off the top of the mountain and look down.

Last week the International Monetary Fund saw fit to warn the U.S. that it is "essential" that the U.S. back up its policy of fiscal restraint with monetary restraint as well. The Fund continued that "it has now become necessary temporarily to restrain demand expansion, so as to bring the growth of real gross national product well below the capacity (growth) rate of 4% and thus to relieve upward pressures on cost and prices and to dampen imports." Translation: we are worried to death that the U.S. is running the dollar into the ground as inflation skyrockets and the U.S. continues to price itself out of the world markets.

What happens if there is a slowdown or even a recession during 1969? In my opinion, any significant drop in corporate profits and individual income (and therefore U.S. tax receipts) could be the start of major trouble of the snowballing variety. A drop of 10% to 15% in tax receipts would send the U.S. Government headlong into the bond market for new financing, thus producing a drastic drop in bond prices and probable new record highs in interest rates.

Along these lines, I thought subscribers would be most interested in this long-term (monthly) chart of the D-J 40-Bond Average. This chart (by M.C. Horsey) provides a 20-year perspective seldom seen. The interesting thing is that the recent, widely-applauded



bond rally appears as a minor "blip" on this chart. In the light of history, the 1968 bond rally has, so far, hardly gotten off the ground, and it is obvious that despite talk of the "highs in interest rates having been seen," the bond market is not yet convinced.

Turning to the economy, there are a few interesting straws in the wind. First of all, many economists predict that real economic growth (G.N.P. adjusted for inflation) will run at an annual rate of only 2% in the second half of 1968, then drop below 2% in the first half of 1969. On top of this, we must remember that the Federal deficit for the year ending June 30, 1968 was a fantastic $25.5 billion. The Bureau of the Budget estimates that for the current fiscal year the deficit will drop to around $5 billion. If the Bureau is anywhere near correct, this will mean a deflationary drop of $20 billion in Federal spending during the current fiscal year.

On top of this $20 billion drop, $3 billion will come out of the consumer sector of the economy through higher Social Security payments. Roughly another $3 billion will be extracted from consumers via retroactive returns on their 1968 income tax because of the 10% surtax. Thus, we have a potential $26 billion drop in the public and private sector, and this could be enough to tip the scales towards deflation.

Finally, Dun & Bradstreet's recent survey shows that 11% fewer business executives expect earnings gains for the fourth quarter of 1968. This wide survey of 1500 executives is important because it deals with the men on the firing line, men who are in a position to guess quite accurately regarding their company's future profit-making abilities.

In summing up, my point is not that there could be a recession in the making, but that this nation has put itself in a position where a recession could have frightening implications. A business with low expenses can easily weather a drop off in sales (income), but a business that is loaded with overhead has put itself in a position where any drop-off in sales could send it into bankruptcy. In private enterprise, a good business which has "gone over its head" can probably merge with another more solvent enterprise. I wonder, if the ball of yarn starts to unravel, who the U.S. Treasury will find to merge with?

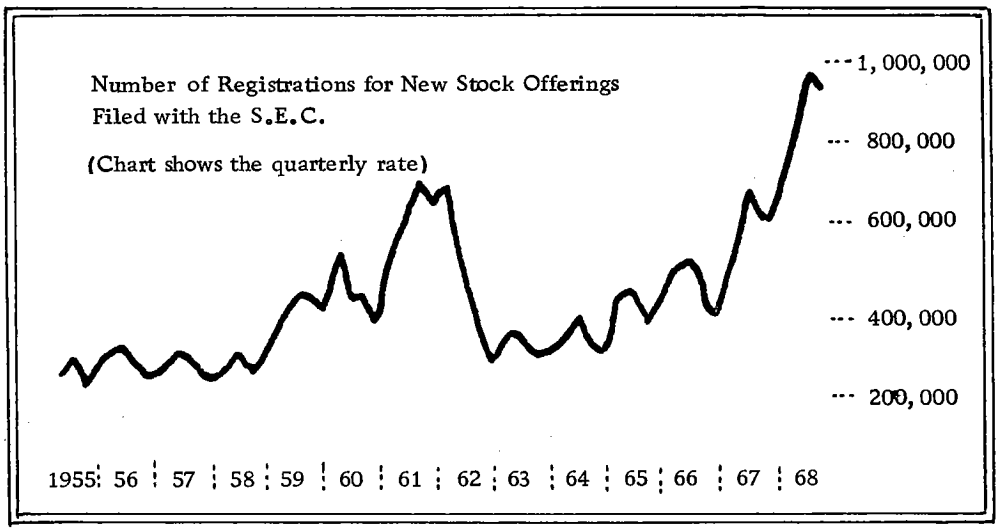


CHART OF THE WEEK: The accompanying chart shows the number of proposed offerings of new stock to the public. Before stock can be offered to the public, the Securities and Exchange Commission requires that a registration be submitted, and this chart traces the number of such registrations.

History suggests that stock is offered to the public at periods when sellers believe that the stock will most likely be taken up at the most advantageous prices. One such period was during late 1959 and early 1960, at a time when the Dow was rushing to an historic high of 685.47 (January, 1960). A second period was during late 1961, at which time the Dow was heading for another historic peak)December, 1961) of 734.91.

The latest period of exploding stock registrations started in 1967 and is continuing as of this writing. The unusual fact about the latest registration rush is that actual stock registrations have climbed far above previous peaks, even though the Dow is not yet near its earlier all-time high of 995.15, set in 1966.

In retrospect we can say that the earlier stock registration booms indicated eras of high exuberance, and that each was followed by an important top in the market. The excitement of today far outpaces 1959-60 or 1961, and (if the chart has any validity) the prospective stock sellers may be overenthusiastic regarding future conditions for stock sale. My own guess is that 1969 is not going to be the sellers paradise which is proving so tempting to stock registrants. Time will tell.

NOTES AND QUOTES: Opinion mistakenly seems to have it that the proposed standby credit by the 12 nations to Britain somehow solves Britain's problems and the pounds problems. It does no such thing. The purpose of the $2 billion stand-by credits is to allow sterling area countries to unload some of their unwanted pounds.

The agreement is that all the sterling area nations will continue to keep a portion of their reserves in sterling. To do this Britain had to pay two prices. First, it had to give a 3-year guarantee that the value of most of the balances remaining in sterling would be fixed in terms of dollars. In other words, in case of another British devaluation, the British would make up the losses to pound holders and thus take on additional debt for themselves.

The second stipulation is that to the extent that the stand-by credits are used, sterling debts will be exchanged into dollar debts within 10 years. This means that the pressure is on to remove the pound as a reserve currency within a decade.

But the whole proposed arrangement hardly guarantees the strength of the pound. It does not underwrite the pound. It merely protects pound holders on a portion of their debt for three years, and sets a policy for pound holders to move into dollar debt rather than pound debt. It does not say the value of the pound will hold. It does nothing towards helping the British trade position. In fact, if the British trade position was healthy, the $2 billion stand-by credits would never have had to be proposed.

* * * *

By most accounts, Hubert Humphrey (unless he turns out to be a latter-day Truman) is washed up. His campaign lacks fire, the liberal following (which has always been the backbone of the Democratic Party) is singularly disillusioned. Indicative is the fact that Humphrey's fund-raising efforts are barely flickering, mostly because potential backers see money for Humphrey as money down the drain.

One spark for Humphrey is provided by the action of the D-J Industrial Average (so far). Since 1900 with two exceptions (1912 and 1940), if the Dow is higher on the day before election than it was on the first day of the year, then the incumbent party is due to remain in power. The closing price for the Dow on the first day of the year was 906.84. As of this writing, the Dow is higher, suggesting that the Democrats will stay in power. But it is not election time yet. If, on the day before elections, the Dow is still above 906.84 the market is suggesting that Humphrey will be an upset victor. But a lot can happen on Wall Street between now and election time.

MARKET LAB.: Last week the golds established what could be the beginning of important upward moves. Typical of gold action was the action of Dome Mines. The monthly chart (courtesy of M.C. Horsey) shows that Dome has been holding above an ascending trendline since 1957, with the upward trend accelerating since 1967. The small, weekly insert chart (courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas) shows the recent action in some detail. Here we clearly see the large triangle which has been formed by Dome over the past few months. At last week's high of 68. Dome had pushed out of its triangle on the upside. A "pullback" by Dome to perhaps the 60-64 area would not be surprising, prior to what could be a major try to the March, 1968 all-time high.